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Lee H. Hamilton, Committee on Foreign
Affairs, House of Representatives

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FOREIGN AID

Problems and Issues Affecting Economic Assistance



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**National Security and
International Affairs Division**

B-225870

December 30, 1988

The Honorable Lee H. Hamilton
Committee on Foreign Affairs
House of Representatives

Dear Mr. Hamilton:

This briefing report provides our response to your April 28, 1988, request that we identify key issues relating to the foreign economic assistance program. As you requested, this report summarizes the major issues and problems we have found in our past and ongoing reviews. Appendix I provides background on the bilateral economic assistance program and our objective, scope, and methodology; appendix II provides specific details on major bilateral issues; appendix III provides information on multilateral assistance issues; and appendix IV a listing of key General Accounting Office (GAO) reports used in our analyses. Appendix V provides agency comments.

Issues and Problems

Some of the more prominent bilateral assistance issues we identified include the following.

- Assistance projects are often undermined by the failure of recipient governments to provide agreed counterpart funding and recurrent cost financing.
- The United States has had significant difficulties in effectively using Economic Support Fund (ESF) assistance and food aid to achieve economic development and policy reform.
- The impact of U.S. assistance is eroded by the deteriorating international debt situation.
- Development assistance programs in narcotics-producing and-trafficking countries have not effectively contributed to narcotics reduction.
- Acquired Immune Deficiency Syndrome may have profound economic and social impacts on developing countries and may increase the demands for U.S. assistance.
- Accountability and control over cash transfers and local currency programs are not sufficient to ensure that assistance is used for intended purposes. Also, adequate attention is not given to the financial management deficiencies of aid recipients.

The Agency for International Development (AID), which is the primary implementing agency for U.S. economic assistance, has encountered significant management problems. Difficulties have been encountered in project and financial management, contracting and procurement, program budgeting, and monitoring. Management of critical programs is complicated by AID's decentralized operations in numerous developing countries, the large number of projects, and direct-hire staff limitations. The pipeline of obligated but undisbursed funds, which has averaged several billion dollars in the 1980s, is indicative of AID's problems in effectively delivering economic assistance.

AID and Department of State officials believe that the congressional oversight and budgeting process is also partially responsible for problems in bilateral assistance delivery. Two frequently mentioned issues are the earmarking of ESF, which can affect AID's ability to promote recipient policy reform, and the funding of development assistance by functional accounts, which can result in development priorities shaped by funding availability rather than development needs. An additional factor cited by AID is the current reprogramming process which requires that AID justify to the Congress most changes in its Congressional Presentation.

Matters for Consideration

We believe several matters deserve congressional consideration. These matters center on whether policy makers should:

- Structure U.S. bilateral assistance according to the recipient's capability to support projects. Options include emphasizing projects that lessen the administrative and financial burden on recipients, stressing alternatives to project assistance, and making new and continued project funding contingent on recipient compliance with counterpart and recurrent cost funding agreements.
- Strengthen efforts to encourage recipient economic policy reform by clarifying specific reform objectives, establishing timeframes/milestones for achieving stated reforms, and periodically assessing reform progress and impact of U.S. assistance.
- Develop budget strategies to minimize the pipeline problem, consider alternatives to earmarking funds and to programming development assistance by functional accounts, and streamline reprogramming requirements.
- Focus AID programs on more manageable units by decreasing the total number of countries in which AID missions and field offices are located,

concentrating AID resources and personnel on key countries and maintaining a limited in-country presence through U.S. embassy staff in other nations, concentrating resources on fewer and/or larger projects, and setting a minimum funding level per project.

- Develop an overall debt relief policy that determines how much aid is needed, the U.S. share, and the most appropriate mechanisms for delivery.
- Determine if AID should play a greater role in U.S. efforts to reduce narcotics production and, if so, what that role should be.

Matters on procedural, management, and operational changes in the bilateral program may be more easily addressed. Some examples include (1) upgrading accountability and control requirements for local currency accounts; (2) developing a fully integrated AID financial management system that, among other things, provides more reliable and comprehensive data on program disbursements; (3) reexamining AID contracting and procurement practices to better ensure competition, cost control, and program effectiveness; and (4) developing a long-term assistance strategy to address the financial management deficiencies of aid recipients.

In the multilateral assistance area, our analysis has indicated the need

- for better management of U.S. participation in international organizations,
- to further strengthen internal evaluation systems and the Joint Inspection Unit of the United Nations,
- to further strengthen the independent evaluation systems of the multilateral banks, and
- for a reliable U.S. policy for assessed payments to the United Nations.

Agency Comments and Our Evaluation

AID and the Department of State commented on a draft of this report.

Overall, AID stated that (1) it believes our analysis understated AID success in using ESF and food aid to achieve development goals, (2) it shares our concern about the need to exercise adequate control over ESF cash transfers and cited a number of steps taken to strengthen controls, (3) it is eager to accept the responsibility for monitoring the use of cash transfers and local currency, but the demands for accountability are increasingly a strain on management and a source of friction with host countries, and (4) its overseas operations may add some complexities to

agency operations, but the benefits in terms of program quality, combined with an enhanced leadership role for the United States, far outweigh the costs.

The Department of State said that:

- It agrees that the United States should try to increase the specificity of its policy reform goals in circumstances where significant political sensitivities do not overshadow other assistance objectives, or economic policy reform measures are not in themselves politically sensitive to the recipient government.
- An evaluation of the costs and benefits of AID's overseas operations versus the headquarters approach used by multilateral institutions is worth pursuing. However, State questioned (1) limiting AID's in-country presence to key countries because of the problems in trying to define key countries and (2) the concentration of AID resources on larger projects because smaller projects can also have substantial benefits.
- It agrees that recipient debt, narcotics, and the spread of Acquired Immune Deficiency Syndrome are major issues affecting U.S. assistance efforts. State believes that other multidimensional issues should be addressed, including environmental degradation and trade relationships with developing countries.
- U.S. assistance efforts have been hindered by U.S. foreign assistance legislation, which over the years has become tied up in multiple and competing objectives.

We believe each agency's comments further demonstrate the difficulties experienced by AID in managing a program which is based on foreign assistance legislation that is increasingly viewed as having too many goals/objectives to effectively implement; requires AID to manage programs with largely political purposes, in the guise of achieving real and lasting economic improvements; and includes approximately 2,000 projects and operations in over 70 countries. Improving the U.S. program will require greater attention to strengthening AID's management capability. Our detailed evaluations of AID and State comments are contained in the appropriate sections of appendix II.

Unless you publicly announce its contents earlier, we plan no further distribution of this report until 10 days from the date of the report. At that time, we will send copies to the Administrator of AID and the Secretary of State. We will also make copies available to other interested parties upon request.

We hope that this analysis will help the Committee on Foreign Affairs in its consideration of the foreign economic assistance program.

This briefing report was prepared under the direction of Nancy Kingsbury, Associate Director. Other major contributors are listed in appendix VI.

Sincerely yours,

A handwritten signature in cursive script that reads "Frank C. Conahan".

Frank C. Conahan
Assistant Comptroller General

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Abbreviations

AID	Agency for International Development
CIP	Commodity Import Program
ESF	Economic Support Fund
GAO	General Accounting Office
PVO	Private Voluntary Organization

Objectives and Scope of Bilateral Economic Assistance

The U.S. bilateral economic assistance program attempts to serve a full range of U.S. national interests: political, economic, commercial, security, developmental, and humanitarian. The United States strives to assist developing countries to find ways to solve seemingly intractable problems of poverty, hunger, disease, and illiteracy. The Agency for International Development (AID) notes that in doing so, the United States has provided over \$100 billion in bilateral economic assistance and more than 300 million tons of food to developing nations.

The bilateral assistance program has become an indispensable part of the growing economic link between the United States and the developing world, providing several benefits to both aid recipients and to the United States. AID has cited numerous examples of recipient benefits, including (1) breakthroughs in agriculture, such as new, high-yielding varieties of grain, enabling nations to become more self-reliant in food and (2) new life-saving technologies in health, such as oral rehydration therapy. Also, a significant portion of bilateral assistance funds are disbursed to a variety of U.S. private and public suppliers of goods and services.

Strategy

The Foreign Assistance Act of 1961, as amended, established the current framework for the U.S. bilateral foreign economic assistance program. The U.S. development strategy initially concentrated assistance on key economic sectors and large infrastructure projects (e.g., dams and roads), with the belief that benefits from this assistance would “trickle down” through all levels of society. A reorientation of U.S. aid policy in the 1970s changed the traditional development strategy by emphasizing those activities that directly addressed the basic needs of the poor. This emphasis led to a rural-oriented development assistance program delivered through an increasing number of small-scale projects.

The current administration emphasizes four basic policy principles: (1) policy dialogue with recipients to eliminate inappropriate economic policies, (2) research and technology transfer to expand and strengthen the capacities of developing countries, (3) institution-building to enhance the growth of viable institutions necessary for successful development, and (4) private sector growth to promote open and competitive markets in developing countries.

Major Programs

AID is the primary implementing agency for U.S. bilateral economic assistance, and its major programs include

- Economic Support Fund (ESF), which provides balance-of-payments assistance, cash transfers, funds for Commodity Import Programs (CIPS), and sector/project assistance;
- Development assistance, which provides loans and grants for projects in key functional areas such as agriculture, rural development, and nutrition; and
- Public Law 480 food programs, which provide U.S. agricultural products to developing countries through concessional sales and/or donations (AID shares administrative responsibilities for this program with the Department of Agriculture).

Major Public Law 480 programs include (1) title I, a concessional sales program, which provides developing countries long-term, low-interest loans to purchase U.S. farm products in exchange for the recipient's use of local currency proceeds from the sale of these products to finance self-help measures and other development projects; (2) title II, which provides food donations for humanitarian purposes; and (3) title III, which provides assistance on a concessional basis and allows for loan repayment forgiveness when local currencies are used for agreed development purposes. Private Voluntary Organizations (PVOs) are often responsible for implementation of title II programs.

AID consists of a central headquarters staff in Washington, D.C., and a number of overseas missions and offices. The headquarters includes the Office of the Administrator, staff offices, and functional and geographic bureaus. AID's overseas presence is maintained by over 40 missions and numerous other field activities. ESF, development assistance, and/or Public Law 480 (titles I and II) program obligations in fiscal year 1988 were scheduled for 80 countries, along with regional and central bureau programs having multicountry coverage.

Funding Levels

For fiscal year 1988, ESF and development assistance programming was estimated to total about \$5.6 billion. In the past 8 years, ESF assistance has grown faster than food and development assistance. ESF now represents about one-half of total bilateral economic assistance and about 90 percent of the funds are earmarked for specific countries—a significant portion is allocated for Egypt and Israel. In recent years, cash transfers have represented an increasingly larger percent of the total assistance program.

In fiscal year 1988, AID's bilateral assistance was programmed throughout the developing world. The top five recipients of ESF, development

Appendix I
 Objectives and Scope of Bilateral
 Economic Assistance

assistance, and food aid in fiscal year 1988 are shown in tables 1.1 and 1.2.

Table 1.1: Top Five Recipients of Economic Support Fund and Development Assistance for Fiscal Year 1988

Dollars in millions			
Economic Support Fund		Development Assistance	
Country	Amount	Country	Amount
Israel	\$1,200	El Salvador	\$66
Egypt	820	Bangladesh	59
Pakistan	220	Pakistan	50
El Salvador	215	Indonesia	40
Philippines	189	Honduras	40

Source: AID

Table 1.2: Top Five Recipients of Public Law 480 Title I, Title II, and Title III Programs for Fiscal Year 1988

Dollars in millions			
Public Law 480, Titles I and III		Public Law 480, Title II	
Country	Amount	Country	Amount
Egypt	\$180	India	\$81
Pakistan	80	Ethiopia	32
Bangladesh	60	Mozambique	20
Morocco	40	Bangladesh	15
Sudan	40	Bolivia	13

Source: AID

Objective, Scope, and Methodology

Our objective was to analyze the results of our past and ongoing work to identify (1) major problems/issues affecting the U.S. foreign economic assistance program and (2) matters for consideration in improving the program. Our analyses have supported efforts of the Committee on Foreign Affairs to examine the effectiveness of the U.S. foreign aid program.

We conducted our analyses from May to July 1988. As requested, we analyzed our past reports on the foreign economic assistance area, focusing on issue/problem identification. We examined relevant GAO reports issued from 1983 through 1988, and included an internal study, which examined foreign economic assistance reports issued from 1973 through 1983. We also considered the results of our ongoing work where applicable. We also met with AID officials participating in related internal agency projects designed to consider the future direction of economic assistance.

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Objectives and Scope of Bilateral
Economic Assistance**

Additionally, we met and coordinated our analyses with officials of the Congressional Research Service, which is conducting separate studies for the Committee.

Our analyses were performed in accordance with generally accepted government auditing standards.

Major Bilateral Problems and Issues

Program Effectiveness

Although the AID programs have had successes, several fundamental program issues need to be addressed in formulating future assistance strategies. These issues include the (1) level of host-country support provided, (2) increasing significance of international debt problems in developing countries, (3) limitations on the use of ESF to achieve policy reform, (4) difficulties in using food aid to achieve policy reform and economic development goals, (5) influence of narcotics production and trade on certain countries' economies, and (6) potential implications of Acquired Immune Deficiency Syndrome.

Host-Country Support

The United States has had difficulties in planning bilateral assistance in line with the host nations' ability to absorb and use the aid. Major problems are indicated by the failure of recipient governments to provide agreed counterpart funding. In one African country, the AID program was seriously affected by the country's failure to meet its funding obligations for project support due to (1) the overall lack of financial liquidity and poor economic conditions in the country and (2) poor control and accountability over funds generated from the sale of Public Law 480 commodities, the major source of funds for the country's development. For one health project, the projected effect of inadequate counterpart funding was significant in terms of direct and indirect economic costs resulting from lives lost, hospitalization, and medical costs.

After AID's involvement ends, projects have sometimes failed to achieve their full potential due to insufficient recurrent cost financing and poor operations and maintenance. Analysis of irrigation projects in Asia demonstrated that because of inadequate operation and maintenance, the systems do not fully meet their agricultural potential and additional donor investments are needed to keep projects operating. In Latin America, analysis indicated a direct correlation between the recipients' deteriorating balance-of-payments positions and their inability to maintain potentially successful projects. Assistance requirements of one of the top five U.S. recipients has exacerbated that country's already large debt burden because of requirements for host country matching funds and recurrent cost financing.

International Debt

The inability of developing countries to service existing debt and borrow new funds hinders the effectiveness of U.S. assistance. During 1987 developing countries experienced a \$29-billion net outflow, largely due

to the interest they paid on their \$1.2-trillion external debt. The magnitude of the problem raises several issues concerning the amount of foreign aid necessary to encourage economic growth in developing countries, the extent the United States can or should intervene in the international debt problems of developing countries, and the aid strategy that is most appropriate for individual countries. Although AID has not played a direct role in the debt crisis, it has adopted economic policy reform, which is designed to address macroeconomic issues such as balance-of-payments problems in developing countries, as a principal objective of many ESF cash transfer programs. AID has helped to encourage reforms in certain countries; however, our reviews indicate that more effective use of cash transfers will require clearer statements of reform objectives, time frames or milestones for achieving reforms, and statements of anticipated impacts of reforms on recipient economic development.

Policy Reform

One of the fundamental objectives of the current administration is to encourage policy dialogue with aid recipients to eliminate inappropriate economic policies that thwart assistance efforts. AID has encouraged economic reforms in some recipient countries through the use of ESF and other programs, but the success of the overall strategy is difficult to determine because (1) other U.S. foreign policy and political objectives constrain AID's ability to strongly pursue reform objectives; (2) other donors, often with substantially more resources, promote similar policy reforms; and (3) changing economic and political events adversely affect or even negate the impact of some reform actions. AID does not consistently set forth clear statements of reform objectives and establish anticipated time frames or milestones for achieving the reforms, which further compounds measurement problems.

Our analysis of specific country programs shows that AID sometimes has been reluctant to condition disbursements on the adoption of specific reforms because of the political pressure to release the funds for reasons unrelated to reform progress. For example, withholding funds for economic reform leverage can be counterproductive to foreign policy or national security objectives by straining bilateral relations, or it can jeopardize national security objectives, such as maintaining access to military bases.

There is also concern that increased earmarking of ESF affects AID's ability to achieve its policy reform goals. Approximately 90 percent of fiscal year 1988 ESF was earmarked for specific countries. Such earmarking is

detrimental, in that recipient countries are normally less willing to agree to reforms that might entail short-run political costs because they know they will receive their ESF anyway. Moreover, earmarking ESF limits funds available for other countries, thus reducing the United States' ability to reward countries engaged in serious economic reform.

Other factors affecting AID's policy reform influence on recipient countries are (1) the strength of the bilateral relationship, (2) the size of the U.S. aid program relative to the magnitude of the recipient's financial needs, and (3) the financial and political costs of specific reforms. An additional issue to consider is the increasing percentage of bilateral assistance that is provided as cash transfers and whether that trend is moving the United States away from the more traditional objectives of development and humanitarian assistance.

Food Assistance

The Public Law 480 assistance program, which includes annual food exports of several hundred million dollars, sometimes has had potentially conflicting goals of encouraging recipient economic development and policy reform, promoting exports of U.S. food, and disposing of surplus U.S. agricultural commodities. Because the food assistance program has largely been driven by the need to promote U.S. exports, there have also been concerns that food assistance hinders developing countries' efforts to expand their food production base. Our review of several mission programs in Africa showed that many missions were not fully using Public Law 480 programs to encourage recipients to change governmental policies, which act as disincentives or give insufficient incentive to increasing agricultural production.

AID's ability to achieve economic development objectives through the Public Law 480 title I program—which provides concessional credits for the purchase of U.S. farm products and provides for the use of local currency proceeds from the sale of food within the recipient country for agreed purposes—can be limited where other U.S. objectives, such as promoting U.S. foreign policy or promoting U.S. agriculture exports, take priority in shaping assistance efforts. In some situations, the use of Public Law 480 as a vehicle for policy reform has proved very difficult because the recipient government controlled marketing of commodities and was reluctant to take risks associated with changes in marketing/ pricing.

Our reviews indicate that inadequate control over the use of local currency is one of the most serious weaknesses in the food aid program.

Title I local currency self-help programs, designed to encourage recipients to take self-help measures to promote economic development, have not functioned as envisioned because (1) some country-to-country agreements were not clear or specific, (2) accountability over local currency has been inadequate, (3) weaknesses have existed in recipient country compliance and reporting, and (4) limited mission monitoring has fostered the attitude that full recipient compliance with agreements is not necessary. These problems are compounded by the fact that AID missions tend to place less emphasis on and devote significantly fewer resources to managing food aid than to other assistance programs.

Our reviews of Public Law 480 title II and III programs over the years have shown a number of obstacles to effective implementation. The title II Food Donation Program has been hampered by (1) lack of reliable estimates concerning recipient food shortfalls, (2) shortcomings in storage, transportation, and distribution networks, and (3) the tendency to be driven, in part, by availability of commodities rather than need. AID missions' oversight of PVO title II programs in Africa largely focused on documenting commodity use and not on assessing PVOs' management of programs and documenting program results and benefits. AID guidance had not established specific requirements for assessing program results, and mission staff assigned to monitoring often had other duties they perceived as higher priority.

Historically, title III has been hampered as a development tool by (1) inadequate programming, organization, and staff to deal with the development uses for food aid, (2) demanding, complex, and multiple program requirements which caused some countries to avoid participation, and (3) competition from the highly concessional food assistance provided under the title I program. Although progress has been made in achieving title III objectives, several obstacles to effective implementation have affected the program, including lack of control and accountability over local currency generated from the sale of commodities, inadequate agreements for monitoring program progress, and lack of mission monitoring.

An emerging issue is that an extended U.S. drought could disrupt food assistance. The linkage between decisionmaking for food aid and overall U.S. agricultural policy could become critical, if significant U.S. production shortfalls occur. In the mid-1970s, exhaustion of surplus U.S. agricultural commodities, expanding commercial export demands, and poor grain harvests created uncertainty over agricultural commodity availability for Public Law 480 programs.

Narcotics Control

Narcotics production in several developing countries is becoming an increasingly serious problem that affects the economic and security interests of both the United States and aid recipients. AID has not been fully successful in reducing narcotics cultivation through crop substitution and area development for a variety of reasons, including the lack of economically viable alternatives to narcotics crops and, in one situation, inadequately designed and poorly administered projects. In one country, AID's programs have had no notable success because project assumptions about host-country commitment to coca (cocaine) control were not fulfilled. In another region, AID officials were unwilling to divert resources from established programs to support U.S. goals of reducing heroin (opium poppy) production.

The Department of State plays the major role in the U.S. bilateral narcotics strategy and its programs include crop control, development and economic assistance, and law enforcement assistance. State Department programs also have not effectively deterred the availability of narcotics to U.S. markets for the following reasons:

- Lack of host-government control over drug growing regions.
- Narcotic laws and extradition treaties favorable to drug producers and traffickers.
- Economic incentives of drug cultivation.
- Uncooperative and hostile governments and/or institutions, and in some cases, *generalized corruption*.
- Shifting production bases.
- Inadequate project management.
- Inadequate evaluations of U.S. program performance.
- The lack of an environmentally acceptable and effective means of chemically eradicating narcotics plants.

U.S. policymakers are giving greater attention to the Department of Defense's role in reducing drug trafficking; however, the impact it might have in this area is not clear.

Acquired Immune Deficiency Syndrome

Acquired Immune Deficiency Syndrome is likely to have profound economic and social impacts on developing countries (e.g., reduced economic output and increased demands on an already overburdened health care system) because large numbers of economically productive, skilled, and well-educated people in urban areas are thought to be at the greatest risk of infection. An effective U.S. strategy for dealing with the issue as a development problem needs to be formulated.

Agency Comments and Our Evaluation

AID believed we understated the success it has had in using ESF and food aid to achieve policy reform and economic development goals. Our evaluations indicate that although AID has had some success in promoting policy reform through the use of ESF, certain recipient governments have not taken the policy measures critical to long-term economic growth. Reasons for this reluctance have varied, but we believe there is recognition among certain recipients that U.S. assistance will continue for political purposes regardless of recipient policy performance.

AID believed it is unrealistic to condition ESF disbursements on the adoption of specific reforms because U.S. leverage is limited by the political and security objectives of ESF, as well as the limitations on U.S. resources in relation to other external assistance provided recipients. AID stated that policy dialogue, as opposed to policy leverage, is the best approach for U.S. assistance. We agree that policy dialogue is an important tool for encouraging policy reform; however, we believe that to the extent cash transfers are justified by policy reform objectives, the United States should adopt sufficient criteria to measure success in achieving those objectives. Such criteria should include statements of specific reform objectives, time frames or milestones for achieving the reforms, and descriptions of the anticipated impacts of the reforms on recipient development.

AID agreed that factors such as the multiple objectives of Public Law 480 and recipient reluctance to make policy changes also limit the development impact of food aid. However, AID believed that the successes of Public Law 480, as evidenced by the Green Revolution and other programs in Asia, outweigh the difficulties. We agree that food aid can be a valuable tool in support of U.S. development efforts. However, our reviews in recent years show that several management weaknesses have affected the program, reducing its impact in encouraging recipient policy reforms and helping to finance agreed development programs. In particular, the failure to ensure adequate control and accountability over local currencies has resulted in lost development opportunities in several countries. In addressing the role of food aid, we believe the fundamental issue is whether AID has sufficient resources to effectively manage a billion-dollar food program that has numerous policy, developmental, and fund-use objectives, while at the same time managing equally demanding and complex ESF and development assistance programs.

AID also believed that certifications required by the Department of Agriculture prevent Public Law 480 from causing substantial disincentives

to local food production in developing countries. We agree that the analytical processes involved in such certifications have helped to avoid the adverse impacts of food aid on local economies. However, we note that in a followup to one of our reports, the AID Inspector General found that title I programs in an African country had discouraged local production because (1) the food aid exceeded the country's annual food deficits and (2) poor planning resulted in U.S. grain arriving during the country's harvest season. We believe this weakness in planning further illustrates some of the management problems that have reduced the effectiveness of specific assistance programs.

Accountability and Control

Major accountability issues have involved the adequacy of controls over ESF direct cash transfers and local currency generated by CIP and food assistance. Control over assistance funds and commodities is further impaired by the fact that recipient financial management systems are often incapable of meeting minimum accounting standards.

Cash Transfers

Because the ESF program has become the largest component of U.S. foreign economic assistance, various accountability issues have faced AID and the Congress in providing dollar assistance. At issue is how to improve financial controls over the large sums of ESF (which grew from \$1.9 billion in fiscal year 1979 to \$3.9 billion in fiscal year 1987) to prevent diversion or misuse.

In the early and mid-1980s, the disposition or use of ESF cash transfer dollars often could not be determined because the funds were commingled with other recipient revenues, and host-country reporting frequently was inaccurate, late, or nonexistent. In one African country, AID disbursed some cash grants despite noncompliance by the recipient with previous agreements and did not always enforce provisions of cash transfer agreements, thus making it easier for the recipient to use funds for purposes and in amounts other than intended. In certain Central American countries, host-country bank controls were nonexistent or too weak to limit the export of hard currency received from U.S. cash transfers.

U.S. legislation now requires special accounts to help track funds. However, the subsequent transfer and commingling of cash transfers used for debt payments and for special circumstances (e.g., foreign exchange and regional monetary unions) make it impossible to verify actual use. AID does not require separate accounts for certain types of ESF sector

grants and project assistance, based on its interpretation of what constitutes a cash transfer, nor does it systematically verify the use of cash transfers or audit special accounts. Also, dollar assistance frees up other host-country funds for uses that may be inconsistent with U.S. objectives.

Local Currency

A basic concept of CIP and Public Law 480 food assistance is that recipients should use local currencies generated from food and commodity sales for agreed purposes. Because local currency proceeds are typically the recipients', U.S. leverage to encourage local currency use for agreed purposes and to ensure adequate accountability and control has been reduced.

Our reviews have shown that because of inadequate accounting, monitoring, and reporting systems for CIP accounts, AID cannot systematically determine whether required deposits are made and whether withdrawals and disbursements are made for agreed purposes. Many CIP programs have not been monitored closely enough to ensure that funds are used as intended. Inadequate accounting and monitoring systems for Public Law 480 local currency have resulted in (1) commingling of funds, (2) host-country failure to establish and/or operate special accounts as prescribed in country-to-country agreements, (3) inadequate AID mission oversight, and (4) failure to enforce compliance with agreements. Thus, control over funds has been lost and, in some cases, host-country officials, agencies, and other public institutions have misused both commodities and funds.

Host-Country Financial Management

Host-country financial management weaknesses have directly contributed to inadequate control over assistance funds, cost overruns, and in some instances, misuse of assistance. Limitations include shortages of trained staff and outdated accounting systems. AID experiences in Africa demonstrate the difficulties in implementing credible programs without at least minimum host-country standards of accountability. Many developing countries believe that improved financial management capability would significantly benefit the performance of development programs. Several countries believe such improvements are important because

- their government accounting systems do not have the capability to meet the accounting and auditing requirements of donor loan and project agreements;

- their accounting and budgeting systems do not have the capability to identify and control the costs of development projects; and
- they have little or no capability to audit development projects, particularly for economy, efficiency, and effectiveness.

Developing countries have indicated that although donors such as AID provide some training and technical assistance to help improve their financial management systems, there is a need for greater donor assistance.

Agency Comments and Our Evaluation

AID said that it shares our concerns about exercising adequate controls over cash transfers and monitoring the use of local currencies. AID cited several examples of its ongoing efforts to improve control and accountability, including updated guidance on establishing special accounts for cash transfers and local currency and the increased use of nonfederal auditors and private accounting firms to tighten controls.

AID said, however, that it is not in favor of having local currency accounting responsibility because of the lack of U.S. ownership, the increased management burden, and the increased friction with host-country governments over imposing U.S. conditions. AID believed its responsibilities should focus on participating in local currency programming decisions and ensuring that funds are used as agreed. We believe that, at a minimum, AID's policy for monitoring local currency use should be upgraded to include systematic verification of host-country reported use. Because billions of dollars in local currency are generated, additional efforts are needed to ensure that such funds are used for stated development purposes and not diverted to other uses.

AID said that it recognizes weaknesses in host-country financial management contribute to inadequate control over foreign assistance funds. However, it also believes that financial management cannot be isolated from public and private management development in recipient countries. AID said its efforts to address the problem include (1) implementation of its Payment Verification Policy in early 1984 which, among other things, requires assessments of host-country financial management and contracting capabilities and financing of assistance through the least vulnerable means based on those assessments; (2) assessment of the auditing and accounting capability of host country institutions that are to receive advances of funds; and (3) selected regional activities directed toward financial management improvement.

We endorse these efforts; however, they do not represent a systematic approach to a problem that is pervasive throughout the developing world. Efforts to strengthen the financial management capabilities of aid recipients should be an integral part of AID's long-term assistance strategy.

AID Management

AID has had difficulties in effectively delivering U.S. bilateral economic assistance—problems have been encountered in managing decentralized operations, staffing, project management, program budgeting, financial management, and contracting and procurement.

Decentralized Operations

Our reviews have shown that compared with other major bilateral donors, the United States has one of the largest and most widespread field organizations for its economic assistance program. AID believes that many field activities are necessary because of the (1) planning and design needs for assistance projects, (2) political advantages of having an in-country presence, and (3) need for policy dialogue to encourage recipient economic policy reform. However, decentralized operations increase the complexity of programming, make management and oversight more difficult, and contribute to increased administrative and program costs. Decentralized operations also made it difficult to determine whether overall AID control policies are fully implemented by field missions and whether individual missions have adopted adequate internal controls.

Staff Levels

AID believes that inadequate numbers of direct-hire staff have affected the quality of management in many areas. The AID Inspector General has noted that the active development assistance project universe is about 2,000—more than one project for every direct-hire employee overseas. It is no coincidence that foreign aid is increasingly conveyed in the form of cash, partially to lessen the administrative burden of monitoring project activities on foreign soil. AID has increasingly used personal service and nonpersonal service contracts to transfer the workload from direct-hire employees.

Additionally, monitoring weaknesses have become endemic to the U.S. program, directly contributing to weaknesses in accountability and control and reducing the effectiveness of assistance programming. AID officials often attribute monitoring deficiencies to limited direct-hire staff resources. Our analysis indicates that inadequate information and

reporting systems for key program activities (e.g., host-country contracting and participant training) have also directly contributed to monitoring limitations.

Project Management

Although improvements have been made, AID's project planning process remains time-consuming and staff-intensive. Project management has been affected by the complexities of projects to directly address the basic needs of the poor in developing countries and the numerous legislative and Agency accountability requirements placed on each project. The number of active projects has grown from about 1,500 in the mid-1970s to about 2,000 presently; this complicates the project review and approval cycle. Projects are often unique and require a full range of management, consultant, and oversight functions, thus creating administrative burdens, diffusing developmental resources, and delaying implementation. Nonproject assistance (e.g., ESF/CIP) has been viewed as offering certain advantages over projects because staff requirements are less and U.S. visibility is enhanced.

The congressional emphasis on directly addressing the basic needs of the poor in developing countries encouraged AID to reorient its development assistance strategy toward numerous small-scale projects which, according to AID officials, caused additional management burdens, less visibility for the United States, less potential for policy leverage, higher administrative costs, and reduced capacity to meet political and/or development objectives. The combination of congressional legislation and AID's concerns about program accountability has contributed to the complexities in project programming. Congressional involvement has had a direct impact on project requirements and, reflecting this, AID has typically prepared a statutory "checklist" of issues that must be addressed during project design.

Program Budgeting

The budgeting process for U.S. bilateral economic assistance programs includes the following complex issues.

- AID's pipeline of obligated but undisbursed funds has averaged several billion dollars in the 1980s, which suggests program/project implementation difficulties.
- The U.S. approach to funding development assistance by major functional accounts, in some instances, has shifted priorities from the development needs of recipients to the need to obligate funds as appropriated. Some AID officials believe that funding by the current

functional accounts limits the Agency's ability to respond to changing development needs. AID officials also believe that other fundamental questions need to be addressed, such as whether (1) there are too many legislative objectives and priorities for AID to effectively implement, (2) the earmarking of funds seriously reduces AID's flexibility to meet critical policy and development objectives, and (3) many of the legislative restrictions and limitations on the use of funds are outdated.

- AID generates several hundred reprogramming notifications annually, representing over \$1 billion in revised budget allocations. Under current legislation, AID must justify to the Congress most changes in its Congressional Presentation. This creates an administrative burden on AID, and relatively few congressional actions are taken on notifications. Oversight and decisionmaking is further reduced by the lack of an AID-wide information system for reprogramming actions.

Financial Management

The lack of a fully integrated AID financial management system has been directly linked to control and accountability problems. Reporting systems have had great difficulty in generating reliable and comprehensive data on assistance disbursements per payee. Efforts are underway to upgrade and integrate AID/Washington and field mission computer systems; however, continued attention will be required to ensure that AID's financial management systems can provide reliable program data and effective internal controls to prevent fraud and abuse.

Analysis of specific assistance programs has revealed fundamental financial management weaknesses. For example, AID's Private Sector Revolving Fund has been hindered by several financial management weaknesses, including (1) a data base that did not accurately project cash flows or appropriations requirements and (2) a lack of complete and audited financial statements. AID's cash management and payment process procedures have also had difficulties in preventing premature program disbursements and excessive cash advances. In some cases, AID directly reimbursed host governments for project payment costs before projects could be inspected.

Contracting/Procurement

AID's primary contracting and procurement activities, which according to AID officials have roughly totaled about \$2 billion annually, involve (1) contracts financed by AID but administered by host-country agencies/ministries/staff; (2) direct contracts with individuals, institutions, and private firms; and (3) direct grants and cooperative agreements with U.S. universities and other institutions. Major problem areas have

included insufficient information on the number and value of host-country contracts, inadequate audit coverage, serious shortcomings in controls over payments for goods and services, and poor project commodity procurement procedures. Recent AID internal assessments indicate that evaluation of the contracting and contract management capabilities of host-country agencies responsible for AID programs is seriously inadequate.

In the direct contracting area, weaknesses have included

- inadequate data and reporting on amendments to direct contracts and noncompetitive contracting actions,
- vague and incomplete scopes of work for contracts and personnel switching by some contractors, and
- inadequate performance indicators in contracts and in contractor reports.

There also has been a failure to ensure that competitive opportunities for centrally managed contracts are fully publicized, adequate monitoring of contractor compliance with such contracts occurs, and sufficient controls exist to make sure that expenditures are charged to the proper account and funds are used only for intended projects.

Agency Comments and Our Evaluation

AID believed our description of its decentralized operations implied an undesirable mode for delivery of U.S. assistance. AID said that better monitoring and greater scrutiny of cash transfers and local currency requires expanded field operations. AID also believed its extensive network of field missions represents the major strength of the United States in the development process. AID described these strengths as (1) including the ability of individual missions to work directly with host governments and (2) providing the Agency with frequent opportunities for leadership among other bilateral and multilateral donors. The Department of State agreed that AID's field presence is often considered a strength of the U.S. program, particularly when compared to other bilateral donors. State believed, however, that an evaluation of the costs and benefits of AID's approach, compared to the centralized structure of the multilateral banks, is worth pursuing.

Our observations about AID's organizational structure do not question the benefits of decentralized operations in terms of enhanced U.S. visibility and dialogue with recipients, nor do they question the obvious benefits of onsite monitoring. Rather, they question whether AID has

stretched itself too thin to effectively manage and exercise prudent levels of accountability over an assistance program that includes approximately 2,000 projects and operations in over 70 countries. We believe that attention needs to be given to the number of country programs and projects that can be effectively managed, while maintaining adequate levels of accountability. It may be necessary to focus AID programs on more manageable units by reducing the number of its overseas missions and other field offices, concentrating AID resources and personnel on key countries and maintaining a limited in-country presence through U.S. embassy staff in other nations, concentrating resources on fewer and/or larger projects, and setting a minimum funding level for projects.

The Department of State questioned the option of limiting the AID program to key countries because of the problems it felt are inherent in trying to define key countries and the desire not to reduce the number of eligible recipients or risk withdrawing assistance to friendly countries. While it is clearly desirable for the United States to provide aid to as many friendly countries as possible, the United States must balance its desires to help developing countries with the realities of today's budget constraints, which are forcing greater attention to the cost effectiveness of all government operations. Unless the United States is willing to commit substantially greater resources to the foreign assistance budget and/or reduce the number of program priorities and objectives, cost and accountability considerations will require a reexamination of how many field operations can be effectively managed.

State also questioned the option of concentrating AID resources on larger projects because small projects can also help recipients. While small projects can be important, there are practical limitations on the number of AID projects that can be effectively managed with available resources. Thus, criteria such as project funding size and/or an emphasis on larger projects should be considered to encourage a more effective scale of operations. To help meet the demands for small-scale assistance, programming through other agencies, such as the Peace Corps, the Inter-American Foundation, and the African Development Foundation, could be considered.

U.S. Participation in Multilateral Assistance Programs

In the 1980s, the United States budgeted several billion dollars for the United Nations and multilateral development bank programs. The appropriate mix of funds to be allocated to bilateral versus multilateral programs has been debated for years. The United States exercises greater influence over its bilateral programs; however, the economic development programs of such institutions as the World Bank, the regional banks, and the U.N. Development Program offer considerable potential. Any effort to improve the performance of the U.S. assistance program needs to weigh the advantages/disadvantages of each type of assistance.

Additional issues concerning U.S. support of multilateral institutions and international organizations have included the need (1) for better management of U.S. participation in international organizations, (2) to further strengthen internal evaluation systems and the Joint Inspection Unit of the United Nations, (3) to further strengthen the independent evaluation systems of the multilateral banks, and (4) for a reliable U.S. policy for assessed payments to the United Nations. The Department of State is responsible for managing U.S. participation in the United Nations and its specialized agencies; the Department of Treasury is responsible for multilateral development bank programs such as the World Bank and the regional banks.

Management of U.S. Participation

There has been a continuing need for the United States to improve the management of its participation in international organizations. Basic weaknesses have been encountered in managing U.S. proposals for reforming and restructuring the U.N. system, including improvements in financial management and evaluations. Our reviews of specific U.N. agency programs showed that more active executive branch agency participation in the State Department's policy management process, and more budget review capability at U.S. missions to U.N. agencies, would help in promoting U.S. budget proposals and programs.

Evaluation Systems

State Department efforts have focused on improving the U.N. internal and external evaluation systems. Limited progress has been made in developing internal evaluation capability and the Joint Inspection Unit has not provided the external evaluation role originally intended, partially due to uneven report quality which reduced report credibility. U.N. agencies also have tended to set aside reports without taking action, and U.N. headquarters has been slow to expand and strengthen internal evaluation systems because of staff limitations. Our reviews of

evaluation systems in the multilateral banks has indicated the need for improvements. For example, our review of the African Development Bank evaluation system led us to conclude that the system is not sufficiently independent as indicated by the lack of (1) full control over the use of staff, (2) a direct line of reporting to the Board of Executive Directors, and (3) an evaluation report recommendation follow-up system.

**U.S. Contributions to U.N.
Agencies**

The United States' unanticipated withholding and deferring of payments contributed to the financial problems experienced by U.N. organizations in the 1986-87 biennium. U.N. financial problems were compounded by the uncertainty over how much or when the United States would pay its assessed contributions. Although the withholdings partially achieved U.S. budget reform objectives, some U.N. and U.S. officials are concerned with the potential long-term negative effects.

Key GAO Reports Used in Our Analysis of Issues on Foreign Economic Assistance

Foreign Aid: Better Management of Commodity Import Programs Could Improve Development Impact (GAO/NSIAD-88-209, Sept. 26, 1988)

Foreign Aid: Issues Concerning AID's Private-Sector Revolving Fund (GAO/NSIAD-88-185, July 18, 1988).

Caribbean Basin Initiative: Impact on Selected Countries (GAO/NSIAD-88-177, July 12, 1988).

Foreign Aid: Improving the Impact and Control of Economic Support Funds (GAO/NSIAD-88-182, June 29, 1988).

Drug Control: Issues Surrounding Increased Use of the Military in Drug Interdiction (GAO/NSIAD-88-156, April 29, 1988).

Drug Control: U.S. International Narcotics Control Activities (GAO/NSIAD-88-114, March 1, 1988).

Drug Control: U.S. Supported Efforts in Burma, Pakistan, and Thailand (GAO/NSIAD-88-94, Feb. 26, 1988).

Food Aid: Integration With Economic Assistance Programs in Four African Countries (GAO/NSIAD-88-96FS, Feb. 25, 1988).

Drug Control: U.S.-Mexico Opium Poppy and Marijuana Aerial Eradication Program (GAO/NSIAD-88-73, Jan. 11, 1988).

Food Aid: Improving Economic and Market Development Impact in African Countries (GAO/NSIAD-88-55, Dec. 21, 1987).

AIDS: Information on Global Dimensions and Possible Impacts (GAO/NSIAD-88-51FS, Oct. 28, 1987).

Foreign Aid: Accountability and Control Over U.S. Assistance to Indonesia (GAO/NSIAD-87-187, Aug. 19, 1987).

Foreign Aid: Improvement Needed in Management of Technical Services Contracts (GAO/NSIAD-87-183, Aug. 18, 1987).

Liberia: Need To Improve Accountability and Control Over U.S. Assistance (GAO/NSIAD-87-173, July 16, 1987).

Foreign Aid: Information On U.S. International Food Assistance Programs (GAO/NSIAD-87-94BR, March 27, 1987).

Liberia: Problems In Accountability and Control Over U.S. Assistance (GAO/NSIAD-87-86BR, Feb. 13, 1987).

Drug Control: International Narcotics Control Activities of the United States (GAO/NSIAD-87-72BR, Jan. 30, 1987).

Foreign Aid: Potential for Diversion of Economic Support Funds to Unauthorized Use (GAO/NSIAD-87-70, Jan. 14, 1987).

United Nations: Progress to Strengthen U.N. Internal Evaluation Systems Has Been Slow (GAO/NSIAD-87-54, Jan. 14, 1987).

Caribbean Basin Initiative: Legislative and Agency Actions Relating to the CBI (GAO/NSIAD-87-58FS, Dec. 8, 1986).

The Philippines: Distribution and Oversight of U.S. Development and Food Assistance (GAO/NSIAD-87-24, Nov. 7, 1986).

Foreign Aid: Improvement Needed in Loan Reporting and Administration (GAO/NSIAD-87-2, Oct. 23, 1986).

Foreign Aid: Questions on the Central American Regional Program Need to Be Resolved (GAO/NSIAD-86-209, Sept. 8, 1986).

Caribbean Basin Initiative: Need for More Reliable Data on Business Activity Resulting From the Initiative (GAO/NSIAD-86-201BR, Aug. 29, 1986).

Foreign Assistance: U.S. Use of Conditions to Achieve Economic Reforms (GAO/NSIAD-86-157, Aug. 25, 1986).

United Nations: More Can Be Done to Strengthen the U.N. Joint Inspection Unit (GAO/NSIAD-86-141, June 17, 1986).

Sudan: Conditions on U.S. Economic Aid (GAO/NSIAD-86-137FS, June 2, 1986).

Foreign Assistance: How the Funds Are Spent (GAO/NSIAD-86-73, March 7, 1986).

Appendix IV
Key GAO Reports Used in Our Analysis of
Issues on Foreign Economic Assistance

African Development Bank: A More Independent Evaluation System Is Needed (GAO/NSIAD-86-48, Feb. 21, 1986).

AID Management: Efforts to Improve Cash Management and the Payment Process at AID (GAO/NSIAD-86-36, Jan. 16, 1986).

Staff Study: Compendium of GAO Reports Pertaining to Public Law 480 from July 1973 through August 1985 (GAO/NSIAD-85-96, Sept. 13, 1985).

Staff Study: Can More Be Done to Assist Sahelian Governments to Plan and Manage Their Economic Development? (GAO/NSIAD-85-87, Sept. 6, 1985).

AID Recognizes Need to Improve the Foreign Economic Assistance Planning and Programming Process (GAO/NSIAD-85-110, Aug. 28, 1985).

Financial and Management Improvements Needed in the Food for Development Program (GAO/NSIAD-85-105, Aug. 7, 1985).

The U.S. Economic Assistance Program for Egypt Poses a Management Challenge for AID (GAO/NSIAD-85-109, July 31, 1985).

U.S. Assistance to Haiti: Progress Made, Challenges Remain (GAO/NSIAD-85-86, June 12, 1985).

Improvements Needed in UNESCO's Management, Personnel, Financial, and Budgeting Practices (GAO/NSIAD-85-32, Nov. 30, 1984).

Financial Management Problems in Developing Countries Reduce the Impact of Assistance (GAO/NSIAD-85-19, Nov. 5, 1984).

Direct Contracting By the Agency for International Development Can Be Better Managed (GAO/NSIAD-84-108, July 9, 1984).

U.S. Economic Assistance to Central America (GAO/NSIAD-84-71, March 8, 1984).

AID Needs to Strengthen Management of Commodity Import Programs (GAO/NSIAD-84-47, Feb. 29, 1984).

Meeting a Basic Human Need: AID's Rural Potable Water and Sanitation Program (GAO/NSIAD-84-34, Feb. 21, 1984).

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Key GAO Reports Used in Our Analysis of
Issues on Foreign Economic Assistance

Economic Support Fund Assistance to the Philippines (GAO/NSIAD-84-44, Jan. 27, 1984).

Irrigation Assistance to Developing Countries Should Require Stronger Commitments to Operation and Maintenance (GAO/NSIAD-83-31, Aug. 29, 1983).

Donor Approaches to Development Assistance: Implications for the United States (GAO/ID-83-23, May 4, 1983).

U.S. Development Efforts and Balance-of-Payments Problems in Developing Countries (GAO/ID-83-13, Feb. 14, 1983).

Comments From the Agency for International Development and the Department of State

AGENCY FOR INTERNATIONAL DEVELOPMENT
WASHINGTON D C 20523

OCT 20 1988

DEPUTY ADMINISTRATOR

Mr. Frank C. Conahan
Assistant Comptroller General
U.S. General Accounting Office
Washington, D. C. 20548

Dear Mr. Conahan:

Thank you for your recent report entitled, Foreign Aid: Problems and Issues Affecting Economic Assistance. As you know, the future of U.S. foreign assistance is currently the subject of extensive study within both the Executive and Legislative branches. This makes the observations of your Agency particularly timely.

Needless to say, we have a number of comments with regard to specific assertions in the report, and I enclose a copy of our response to some of the more salient issues raised in the report. I hope you can take them into account. We may, in the near future, have some more general comments to transmit to you as well, since this Agency has also been looking at the broad problems of economic development administration.

I thank you for your interest in our efforts.

Sincerely,


Jay Morris

Annex I

A.I.D. Response to Issues and Problems Raised
in GAO Report on Foreign Assistance

Program Effectiveness

The report asserts that "The United States has had significant difficulties in effectively using Economic Support Fund (ESF) assistance and food aid to achieve economic development and policy reform goals." A.I.D. believes that this statement and the discussion of these issues in the report does not portray the process accurately and therefore understates the success A.I.D. has had with these programs.

ESF serves a dual purpose: it is simultaneously development and security assistance. While we hope to maximize the development benefits of ESF, it is still recognized by statute to be a political as well as an economic tool. There are instances where the balance will tip in favor of the political in determining whether or not to disburse funds. That is inevitable given the nature of the account.

We do not believe it is realistic to expect A.I.D. to condition disbursements on the adoption of specific reforms, as is suggested in the report. Many of the countries we work with would not accept what would be perceived as an infringement on their national sovereignty. None would accept changes in policies which their national leadership did not accept as fundamentally in their best interests. Furthermore, our resources in many countries are a fraction of external assistance and our ability to leverage policy change is therefore limited.

Rather than focussing exclusively on conditionality, we have built a good deal of strength in policy dialogue through the credibility of our advisors, appropriate technical assistance, support for important research, and staff discussion with policy-makers. We have had substantial success with this approach, particularly at the sectoral level, in countries such as Pakistan, Indonesia, Bangladesh and even Egypt.

The report reflects a simplistic perspective that the USG should expect a quid pro quo in a specified short-term period for the assistance it provides. That is, it views USG policy initiatives more in the context of "policy leverage" as opposed to "policy dialogue". Our experience has demonstrated that the policy dialogue approach, which entails sustained discussions over perhaps several years, is the best approach.

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As regards food aid, the report asserts that the PL480 program has had limited development impact because of multiple objectives and the reluctance of recipient governments to take risks associated with changes in marketing or pricing. A.I.D. of course acknowledges these factors, but believes that the successes outweigh the difficulties. For example, the Green Revolution in Asia is attributed largely to policy dialogue and research supported through the India Title I program. Food security in Bangladesh has been much improved through policy and local currency initiatives pursued through the Title III program. The report further contends that food assistance hinders countries' efforts to expand their indigenous food production base. It is worth noting that the Secretary of Agriculture must certify that food aid programs will not cause substantial disincentives to local production and marketing. Where such concerns exist, the issue is analyzed and dealt with before the food is shipped.

Accountability and Control

The report describes the growth of the ESF program and the accompanying concern over exercising financial controls to prevent diversion or misuse. A.I.D. shares this concern and has pursued a practical strategy to exercise control over these funds.

Pursuant to legislation, in October, 1987 A.I.D. issued guidance requiring overseas missions to establish special accounts for both ESF cash transfer dollars and any required generations of local currency. The cable guidance covered a variety of programs, from Central America to monetary unions in the Sahelian countries of West Africa. We are closely monitoring compliance with this policy and have refined our reporting procedures so that the Agency Controller can better assess compliance. In addition, under the Federal Managers Financial Integrity Act, the Agency is requiring all overseas missions to assess and test various specific control techniques related directly to policy compliance.

A.I.D. has also begun promoting the use of non-federal auditors to improve verification standards. Indeed, a recent survey of overseas missions reflects that significant progress is being made in utilizing qualified private accounting firms in the areas of financial management and auditing. We intend to build on this progress and recently issued another guidance cable which urges all missions with ESF cash transfer agreements to use private accounting firms to develop and implement adequate accounting systems to allow proper tracking of dollars as well as local currencies.

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A.I.D. is eager to accept responsibility for monitoring the use of cash transfer dollars and local currency, but we need to make sure that we do not inadvertently contribute toward the bureaucratic wastefulness and inefficiency that both A.I.D. and the House Foreign Affairs Committee are looking to minimize or eliminate. Increasing demands for the Agency to account for and oversee the use of resources not owned by the U.S. are becoming more costly in terms of management attention, operating expenses, and ultimately in mutual confidence between A.I.D. and the Congress. In addition, they are a source of increasing friction with host country governments when A.I.D. is required to impose USG conditions on what governments perceive as their own resources.

Technically, our accounting responsibility is limited to funds we own, though we have a management interest in resources over which we have some programming influence. A.I.D. should participate in local currency programming decisions, must be satisfied that funds are used as agreed and that host countries take adequate steps to assure effective oversight. However, we do not agree that the U.S. can or should impose and oversee U.S. accounting control over these currencies. It is more than an "understanding" that local currency belongs to assistance recipients. It is a fact that underlies A.I.D.'s financial management decisions.

As regards host-country financial management, A.I.D. recognizes that weaknesses in these systems contributes toward inadequate control over foreign assistance funds. However, it is also true that financial management performance is an integral part of the modernization process and cannot be isolated from public and private management development in host countries.

In early 1984, the Agency implemented its Payment Verification Policy Statements which, among other things, required missions to assess the financial management and contracting capabilities of the host governments at the project design stage. Based on these assessments, the least vulnerable methods of financing and implementation are to be utilized. Given the evolutionary nature of these policies, the Agency is satisfied with the progress being made to date in the implementation of the payment verification policies. For example, as of December, 1987, the overseas missions had formally reviewed 61% of host country agencies with host country contracts.

The Agency's project and financial management systems also require that we assess the accounting and audit capability of host country institutions that are to receive advances of funds. Where they are found to be weak to unacceptable, A.I.D.

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must supplement its own internal review and audit processes to improve internal controls. In addition, A.I.D. performs more detailed voucher reviews and contracts with private accounting firms to work with host country institutions on their financial management capabilities. As an example, A.I.D. has a regional activity in Latin America directed toward financial management improvement. Where host governments demonstrate an interest in pursuing governmental financial management reform, A.I.D. stands ready to assist in these efforts.

A.I.D. Management

Finally, the report notes that a unique and perhaps undesirable feature of the USG foreign assistance program is its implementation through an extensive network of field missions. Better and broader accountability requires greater presence in the field. Greater scrutiny of the uses of local currencies by host governments perforce means expanded field operations. The same is true for expanded monitoring of the use of dollars provided under cash transfers. We can't have it both ways: more centralized operations and better monitoring of local currency generations or cash transfer dollars are mutually exclusive.

Beyond the monitoring function however, lies the real value of overseas missions. No major donor would disagree that the major strength of the United States in the development assistance process is drawn from its overseas presence. This creates the relationships, fosters the dialogues and makes A.I.D. relevant far beyond the level of resources it commits to any one country. Given the diversity of country contexts and need, missions must have the authority to make independent program decisions and to negotiate directly with host governments in a timely manner in order to be responsive. While the structure may add some complexity to Agency operations, the benefits in terms of program quality and impact far outweigh the costs. In addition, A.I.D.'s field structure provides us with frequent opportunities for leadership among both bilateral and multilateral donors, further increasing U.S. influence.

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United States Department of State

Comptroller

Washington, D.C. 20520

September 30, 1988

Dear Mr. Conahan:

I am replying to your letter of September 7, 1988 to the Secretary which forwarded copies of the draft report entitled Foreign Aid: Problems and Issues Affecting Economic Assistance (Code 472159) for review and comment.

The enclosed comments on this report were prepared in the Bureau of Economic and Business Affairs.

We appreciate the opportunity to review and comment on the draft report.

Sincerely,

A handwritten signature in black ink that reads "Roger B. Feldman".

Roger B. Feldman

Enclosure:
As stated.

Mr. Frank C. Conahan,
Assistant Comptroller General,
National Security and
International Affairs Division,
U.S. General Accounting Office,
Washington, D.C. 20548.

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GAO DRAFT REPORT COMMENTS: FOREIGN AID: PROBLEMS AND ISSUES
AFFECTING ECONOMIC ASSISTANCE (CODE 472159)

The draft GAO report is generally useful in focusing attention on some problems and issues affecting economic assistance. The comments (copy attached) that we provided on the June 1988 GAO report on economic support funds (GAO/NSIAD-88-182) also apply to this report. We agree that a recipient country's commitment to economic reform and its ability to manage a reform program are critical to a productive use of economic assistance. However, we note once again the problems associated with setting clear and transparent targets in economic policy reform programs. We concur that earmarks and functional mandates limit our ability to respond positively to countries which undertake economic reform programs.

The draft GAO report calls for consideration of decreasing the number of AID field offices, concentrating on key countries and focusing on larger projects. It might be useful to review the effectiveness of the field vs. headquarters approaches to administering economic assistance in a more systematic way than this GAO report has done before drawing such a conclusion. While AID's field presence is often considered one of its strengths, particularly when compared to other bilateral economic assistance programs, the multilateral development banks have generally taken a headquarters approach. An evaluation of the costs and benefits of the two approaches is worth pursuing.

We question the idea of limiting US economic assistance to key countries because of the problems inherent in trying to define key countries. While the Administration already balances many national security and economic interests in allocating foreign assistance under existing legislation, we do not want to decrease the number of eligible recipients or risk cutting off assistance to friendly developing countries, because they do not meet a new, more limited set of key country criteria.

We also question the idea of concentrating resources on larger projects. A small technical assistance/training project which increases the management capabilities of an aid recipient can be as important to the overall success of an economic assistance program as a large grant to support a recipient's balance of payments. Development literature is filled with such examples.

We enthusiastically endorse the GAO recommendation that Congress consider alternatives to earmarking of funds and programming of development assistance by functional accounts. Over the years US foreign assistance legislation has become

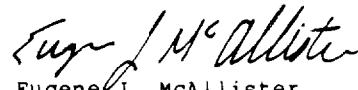
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tied up in multiple and competing objectives with more objectives and mandates than resources to meet those objectives and mandates. Earmarks hinder US efforts to encourage economic policy reform and functional programming limits US flexibility in responding to developing country needs. (See comments on GAO/NSIAD-88-182.)

We agree that debt is a major issue. Our debt strategy, as outlined in the Baker Plan and the menu approach, is aimed at supporting a market-based, case by case approach to the debt problems of individual countries.

The GAO report also points to acquired immune deficiency (AIDs) and narcotics production and trafficking as major issues affecting US economic assistance programs. Narcotics and AIDs are issues of major concern, but the economic implications of these issues vary from region to region. Thus, narcotics and AIDs might be more effectively addressed in a regional context. The GAO report, however, does not mention the environment as a concern for economic assistance programs and certainly it is important to sustainable development worldwide. There are other issues which impinge on economic assistance such as the trends in developed country economies, the terms of trade, and trade and budgetary policies. The US cannot control all the elements that determine the success or failure of our economic assistance, but should allow for flexibility in setting economic assistance objectives and administering economic assistance projects and programs.


Eugene J. McAllister
Assistant Secretary
Bureau of Economic and
Business Affairs

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GAO DRAFT REPORT COMMENTS: FOREIGN AID - IMPROVING THE IMPACT
AND CONTROL OF ECONOMIC SUPPORT FUNDS (CODE 472131)

The draft GAO report generally does a good job of indicating the constraints faced by the U.S. Government (USG) in trying to use cash transfer ESF to encourage economic policy reform in developing countries. We agree that economic assistance in the absence of a policy environment conducive to economic growth is not the ideal use of ESF, and that cash transfer assistance provides more leverage for reforms than either project or CIP assistance. Commitment to reform by the recipient country government is a critical determinant of a successful reform program. The USG has a better chance of achieving policy reforms, other things being equal, when sensitive political factors do not constrain our ability to condition the assistance in a credible way on reform actions that the recipient country must take. Short-run political considerations can work against the medium-to-long term efforts to persuade the recipient country to achieve a self-sustaining and stable economy.

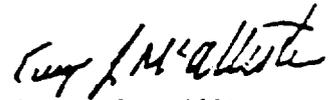
The draft report notes that over 90 percent of ESF funds are currently earmarked. Although GAO mentions that Congressional restrictions on the use of ESF funds often constrain their effectiveness for economic policy reform, the report does not give sufficient weight to the role of earmarking in this regard. When ESF funds are earmarked for a particular country, our ability to use the funds as leverage for policy reform is seriously undermined. The government benefiting from the earmark, knowing that it will almost certainly receive the funds in any case, is normally less willing to agree to reforms which may entail short run political costs. Alternatively, by severely limiting funds, available for non-earmarked countries, earmarking sharply reduces our ability to reward friendly governments engaged in serious economic reform efforts with ESF which could encourage further reform and cushion the adverse impact of adjustments on the populations concerned.

We do not quarrel with the GAO recommendation that the USG increase the specificity and transparency of its policy reform goals so that the results of these efforts become easier to evaluate. However, we would caution that, in situations of great political sensitivity, our ability to establish specific goals which have a reasonable chance of accomplishment may be very limited. In addition, in countries in which discussion of economic policy reform measures is politically sensitive, the very act of establishing fixed reform targets in advance can

Appendix V
Comments From the Agency for International
Development and the Department of State

undermine the government's ability to undertake reforms by fueling public opposition to perceived external domination of economic policy making. The GAO recommendation could have the unanticipated consequence of discouraging USG efforts at stimulating policy reform in cases where political factors imply great risks of failure. In some situations a less specific economic reform program which allows us to discuss economic reform issues with key officials of the recipient government may be preferable to a highly specific program with unrealistic expectations. In the latter case, our credibility on economic policy issues with the recipient government could be seriously damaged, and our efforts will be counterproductive to improved economic performance.

We do not endorse the view expressed by one A.I.D. official that, if Congress really wants policy reform, it should divide ESF into separate accounts directed at either economic policy reform or political/security objectives. This would run counter to the flexibility which the GAO report rightly says is necessary for successful implementation of ESF programs under varying conditions. It also would tend, in many cases, to reduce the impact our ESF has for either type of objective. Ultimately, achievement of economic and political stability as well as self-sustained growth in friendly developing countries directly serves our overall political and strategic objectives.



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